

AUDIT MANUAL

Chapter 12

Construction Contractors

NOTICE:

**CONTENT OF THIS CHAPTER IS
CURRENTLY UNDER REVISION.**

**PLEASE CHECK THIS FILE
PERIODICALLY FOR UPDATES.**

Sales and Use Tax



Department of Business Taxes
California State Board of Equalization

CHAPTER 12

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CHAPTER 12

CONSTRUCTION CONTRACTORS

1200.00

INTRODUCTION

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GENERAL

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This chapter is a guide for determining sales and use tax liability of construction contractors. The chapter does not cover all phases of auditing problems that may be involved as they are too numerous and complex. In all cases, the auditor should refer to the provisions of Regulation 1521, Construction Contractors, and to pertinent legal interpretations.

The term “contractor”, as used herein, includes both general contractors and subcontractors who perform contracts for erecting, remodeling, or repairing a building or other structure on land. The essential factor is that for the contractor to fall within the specific taxing provisions applicable to contractors he must install the property in a manner by which it is incorporated into the realty. Thus broadly speaking, a contractor is a person who makes improvements on or to real property.

TYPES OF CONSTRUCTION CONTRACTS

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Contracts for improvements on or to real property are principally of three general types as follows:

a) *Lump Sum*

A contract which fixes the amount to be paid to the contractor as a single amount.

b) *Cost Plus*

A contract which itemizes the cost of tangible personal property, which may include tax, labor, overhead and other costs, plus a certain fee or percentage in addition to cost.

c) *Time and Material*

A contract which specifies material and fixtures at retail or at some other agreed price plus labor, etc., at an agreed price.

WHEN PROPERTY IS NOT INSTALLED

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Frequently a contractor, because of union regulation or other contract stipulation, may merely deliver a portion of the materials or fixtures to the “jobsite — not installed.” Even though the entire contract may be lump sum, where any such property is delivered to the job and not installed by the contractor, a sale of tangible personal property has been made, the transaction is not an improvement to realty. Sales tax should accordingly be computed upon the fair retail selling price of such items, which generally is accomplished by taking the cost of materials, labor and overhead applicable to the property not installed, plus the profit ratio on the job. From an auditing standpoint, the auditor accordingly should verify from taxpayer’s cost records, contracts, etc., that installation was made by taxpayer, or other installer hired by him. The contractor, or subcontractor, in other words must hold the contract for, and have the property installed. For example, should a subcontractor deliver fabricated materials or fixtures to a prime contractor who will make the installation, there has been a sale of tangible personal property rather than a subcontract to improve real property.

WHEN PROPERTY INSTALLED IS “MACHINERY AND EQUIPMENT”

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This is considered as a sale and installation of tangible personal property rather than an improvement to realty since “machinery and equipment” is not accessory to the building and does not serve a function of the building itself.

CONSTRUCTION CONTRACT PROCEDURE**1201.30**

A sequence of events that may occur in a construction contract follows:

- a) Examination by the contractor, of the plans and specifications and the invitation to bid.
- b) Preparing bill of materials and estimating cost of materials plus tax thereon, labor, overhead and profit.
- c) Submission of a bid to the owner or general contractor.
- d) Signing of contract and obtaining a building permit.
- e) Stages of construction with inspection, progress billings, retention.
- f) Completion, completion notice and final billing.
- g) Changes, additions and deletions at an agreed price. These may come through as various change order numbers on large jobs or simple oral agreements on some home construction.

CONSTRUCTION CONTRACTORS RECORDS OF GENERAL CONTRACTORS

1202.00

GENERAL LEDGER

1202.05

This may include several accounts peculiar to contractors who wish to set up as a liability the contracts which he is obligated to perform, and the discharge of that liability as the job progresses and progress billings are made.

Examples:

- Progress billings.
- Billing retention

BOOKS OF ORIGINAL ENTRY

1202.10

These may be similar to those of a retailer or manufacturer. The purchase journal and/or cash disbursements journal may show material purchases charged to inventory or directly to specific construction job numbers. Sales journal may reflect progress billings on lump-sum contracts, over-the-counter sales and time and material contracts with separate columns for labor, material or fixture sales price and sales tax charged.

SUBSIDIARY RECORDS

1202.15

Subsidiary records may include the following:

- a) Contract register with columns for contract number, owner's name, job location, brief description of job, type of contract, total amount of contract and date completed.
- b) Contract job cost journal showing in columns such items as material cost, labor, overhead, subcontracts, etc., for the various jobs in process and a total for all jobs in process to date for a particular accounting period. Subtracting the totals of the previous period shows the cost for the current accounting period. Job cost ledger cards also may be kept.
- c) Requisition journal recording materials and fixtures withdrawn from inventory through requisitions.

SUPPORTING DOCUMENTS

1202.20

Supporting documents may include the following:

- a) Billings, both progress and final.
- b) Job cost folders:
 - 1) Plans and specifications
 - 2) Estimate of costs
 - 3) Copy of contract
 - 4) Copy of purchase invoices for direct charges to job
 - 5) Copy of requisitions for material withdrawn from inventory
 - 6) Time cards for both in-plant labor and labor at jobsite.
- c) Files of paid purchase invoices.

HOW TAX APPLIES TO CONSTRUCTION CONTRACTORS**1203.00****CONSTRUCTION CONTRACTORS GENERALLY****(OTHER THAN U.S. CONTRACTORS) EFFECTIVE APRIL 1, 1976****1203.05**

Effective April 1, 1976, the tax applies to construction contractors generally as follows:

- a) **MATERIALS** – Contractors are consumers of materials which they furnish and install in the performance of construction contracts, and tax applies to the cost of materials to the construction contractor. However, a construction contractor may contract to sell materials and also to install the materials sold. If the contract explicitly provides for the transfer of title to the materials prior to installation, and separately states the sale price of the materials, exclusive of the installation charge, the contractor will be considered the retailer of the materials.

In the case of a time and material contract, if the contractor bills his customer an amount for sales tax computed upon his marked up billing for materials, the contractor is considered to be the retailer of materials and is subject to tax on the amount upon which tax reimbursement is charged. If the sale occurs in this state, the sales tax applies to the contractor's gross receipts from the sale of the materials. If the sale occurs prior to the time the property is brought into this state, the contractor's customer is the consumer, and his use is subject to use tax measured by the sales price. The contractor must collect the use tax and pay it to this state.

When a contractor fabricates or processes material prior to installation, no tax is due on such processing costs; only the contractor's actual material cost is subject to the tax. Where the contractor sublets fabrication or processing of material to an outside firm, such fabrication is considered part of the taxable cost of materials.

- b) **FIXTURES** – Contractors are the retailers of fixtures which they furnish and install, and tax applies to their sales of the fixtures. If the contract states the selling price of the fixture, tax applies to that price. If no sales price is stated, the taxable retail selling price is the cost price of the fixture to the contractor. If the contractor purchases a manufactured fixture, the cost price is the sales price of the fixture to him, including any manufacturer's excise tax or import duty imposed prior to the sale by the contractor. However, if the contractor manufactures the fixture, the cost price is:
 - 1) The prevailing price at which similar fixtures in similar quantities ready for installation are sold to contractors, or
 - 2) If similar fixtures are not sold to other contractors, then the cost price shall be deemed to be the amount stated in the price lists, bid sheets, or other records. If the sale price cannot be established in the above manner, the cost price shall be the aggregate of the following:
 - A) Cost of materials, including freight-in and import duties; direct labor, including fringe benefits and payroll taxes; specific factory cost attributable to the fixture; any manufacturer's excise tax; pro-rata share of all overhead attributable to the manufacture of the fixture; and reasonable profit from the manufacturing operations which, in the absence of evidence to the contrary, shall be deemed to be 5 percent of the sum of the preceding factors.
 - B) Jobsite fabrication labor and its prorated share of manufacturing overhead must be included in the sale price of the fixture. Jobsite fabrication labor includes assembly labor performed prior to attachment of a component or a fixture to a structure or other real property.

CONSTRUCTION CONTRACTORS
CONSTRUCTION CONTRACTORS GENERALLY
(OTHER THAN U.S. CONTRACTORS) PRIOR TO APRIL 1, 1976

1203.10

Prior to April 1, 1976, tax applied to construction contractors generally as follows:

- a) **MATERIALS** — Contractors are consumers of materials, and tax applies to the cost thereof in lump-sum, cost-plus, and time and material contracts provided no tax reimbursement is charged. In the case of a time and material contract, if the contractor bills his customer an amount for “sales tax” computed upon his marked up billing for materials, it will be assumed, in the absence of convincing evidence to the contrary, that he is selling the materials.

When the contractor fabricates or processes material prior to installation, no tax is due on such processing costs; only the contractor’s actual material cost is subject to the tax. Where the contractor sublets fabrication or processing of material to an outside firm, such fabrication is considered part of the taxable cost of materials

- b) **FIXTURES** — Construction contractors are retailers of fixtures which they furnish and install in the performance of construction contracts. If the contract states the sale price at which the fixture is sold, tax applies to that price. However, if the sales price of the fixture is not stated in the contract, then the sale price shall be deemed to be the cost price of the fixture to the contractor. The taxable measure is the cost price of fixtures on a time and material contract where fixtures and materials are billed as a single amount, and sales tax reimbursement is not collected on more than the cost price of the fixtures and material. Where the contractor is the manufacturer of the fixtures, the cost price is:
 - 1) The prevailing price at which similar fixtures in similar quantities ready for installation would be sold to contractors, or
 - 2) If like fixtures are not sold to other contractors, the value placed on fixtures as indicated from contracts, price lists, bid sheets or other records where the value is not less than the manufactured cost of the fixtures computed as follows:
 - A) Cost of materials, including freight-in; direct labor, including fringe benefits and payroll taxes; specific factory costs attributable to the fixture; and pro-rata share of overhead attributable to the fixture.
 - B) The manufactured cost will not include selling expense, contracting expense, any element of profit, freight and delivery costs from plant to jobsite, and pro-rata share of overhead which is attributable to functions other than the manufacturing process.

UNITED STATES CONTRACTORS EFFECTIVE APRIL 1, 1976

1203.15

Effective April 1, 1976, tax applies to U.S. construction contractors as follows:

- a) **MATERIALS AND FIXTURES** — U.S. construction contractors are the consumers of materials and fixtures which they furnish and install in the performance of construction contracts with the United States Government. Either the sales tax or the use tax applies with respect to sales of such property to U.S. construction contractors. There is no distinction between the application of tax to materials and fixtures. Only the cost is subject to tax (even though the fixtures are self-manufactured).
- b) **MACHINERY AND EQUIPMENT** — U.S. construction contractors are retailers of machinery and equipment furnished in connection with the performance of a construction contract with the United States Government. Tax does not apply to sales of machinery and equipment to U.S. contractors or subcontractors, provided title to the property passes to the United States before the contractor makes any use of it. The contractor may issue a resale certificate. However, if the contractor uses the machinery or equipment before passage of title to the United States, then the contractor is the consumer of the machinery or equipment and either sales tax or use tax applies to the sale to or the use by the contractor of the machinery and equipment.

- c) **PURCHASES AS AGENT OF THE UNITED STATES** — As a result of recent court cases, purchases of property by a contractor who is authorized to act as “agent of the United States” for such purchases are exempt from both the sales and use tax (effective through December 31, 1978 only). However, on and after January 1, 1979, purchases of property by a contractor so authorized are subject to sales tax, but not the use tax.

UNITED STATES CONTRACTORS PRIOR TO APRIL 1, 1976**1203.20**

Prior to April 1, 1976, tax applied to U.S. construction contractors as follows:

- a) **MATERIALS AND FIXTURES** — The contractor is the consumer of all tangible personal property used on government contracts involving improvement to realty, and there is no distinction made between materials and fixtures. Either the sales tax or the use tax applies with respect to sales of such materials and fixtures to U.S. construction contractors. Only the material cost is subject to tax on fixtures, even if they are self-manufactured.
- b) **MACHINERY AND EQUIPMENT** — Tax does not apply to sales of “machinery and equipment” to U.S. construction contractors if the following conditions are met:
 - 1) It is not used by the contractor in making the improvements (as distinguished from supplies and tools, such as steam shovels, cranes, trucks, and hand or power tools, actually used to perform construction work).
 - 2) It either is not attached to the realty or, if attached, is readily removable as a unit (as distinguished from “fixtures”).
 - 3) It is installed for the purpose of performing a manufacturing operation or some other function not essential to the structure itself.
 - 4) Title to the property passes to the United States before the contractor makes any use of it.
- c) **PURCHASES AS AGENT OF THE UNITED STATES** — As a result of recent court cases, purchases of property by a contractor who was authorized to act as “agent of the United States” for such purchases are exempt from both the sales and use tax.

CONSTRUCTION CONTRACTORS AUDIT PROCEDURE — BASIC CONCEPT

1204.00

GENERAL

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Procedures for auditing a construction contractor generally vary substantially from those for a regular retailer in that to a great extent the contractor is responsible for tax only on his cost, rather than his billed price. Thus, in most cases, an audit of a construction contractor is completed on a taxable measure basis, and in a manner whereby not only retail sales, but all material costs are accounted for.

It is apparent that in this industry, the methods and size of operation, accounting, and reporting methods vary greatly; and not only is it impossible to prescribe an inflexible audit program to be followed in all cases; it is not desirable. The auditor himself must assume the responsibility for planning and performing verifications appropriate for each particular set of circumstances encountered. The auditor should be in a position to do this after he:

- a) Has a thorough understanding of the application of tax to construction contractors,
- b) Is thoroughly familiar with the various special provisions of the law and regulations applicable to contractors,
- c) Has knowledge of the fundamental verification guidelines, and
- d) Has performed the analysis and planning procedures outlined below.

AUDIT PLANNING

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Certainly the best foundation to sound audit planning is a complete understanding of the facts. The auditor should prior to planning his verification program determine:

- a) **THE SCOPE OF ACTIVITIES** — In what type of contracting is the taxpayer engaged? Does it involve materials, fixtures, or both, and is he also engaged in making retail sales? Are contracts performed for the United States Government?
- b) **HOW THE TAXPAYER BILLS AND CONTRACTS** — Although the taxpayer's method of billing is important, the real concern of the auditor is how the taxpayer contracts with his customers, i.e., lump-sum, time and material or cost plus.
- c) **HOW THE TAXPAYER PURCHASES** — Does taxpayer purchase materials and fixtures on an ex-tax, tax-paid, or mixed status basis?
- d) **HOW THE TAXPAYER RECORDS AND REPORTS** — This is the vital key to effective audit planning, for not only must the auditor be aware of the taxpayer's methods, he generally can make use of data already accumulated by the taxpayer.

NOTE: Essential information about any of the above areas of the contractor operations which are not included under the "General Comments" section of Form BOE-414-A should be covered in the audit verification comments.

AUDIT MANUAL

FUNDAMENTAL VERIFICATION GUIDELINES

1205.00

TOTAL SALES

1205.05

Liability for contracting operations normally should be verified on a taxable measure basis. Verification of gross sales generally should be confined to examination and control of revenue and other general ledger accounts to insure accounting for all classes of transactions.

Typical examples of other than normal operations might be rentals, joint venture operations, dispositions of fixed assets, etc.

TAXABLE BASIS OF CONTRACT

1205.10

- a) **CONTRACTOR ON TAX—PAID BASIS**—Some contractors responsible only for tax on cost may elect to pay tax at source, or report all ex-tax purchases on Line 2; thus placing them on a tax-paid basis. In such instances, auditor should verify that taxpayers are actually responsible only for tax on the purchase cost, and that all purchases are properly tax paid or reported. It should also be verified that opening inventory is made up of tax-paid purchases or purchases previously reported as taxable.
- b) **CONTRACTOR NOT ON TAX-PAID BASIS — Cost Accountability** — The actual source of fixtures, materials, and supplies used on jobs are generally:
 - 1) Direct purchases for specific jobs
 - 2) Withdrawals from inventory

Some contractors maintain detailed and complete job cost records and are able to report directly from job cost folders, which normally contain details of purchases made directly for specific jobs, and stock requisitions for inventory withdrawals. Some contractors report estimated costs.

Unless the contractor is on a tax-paid basis, *the auditor as standard procedure should prepare a reconciliation accounting for all costs.*

- c) **EXAMPLES OF ACCOUNTING FOR COSTS:**

Example #1 — **CONTRACTING OPERATIONS ONLY —**

TAXPAYER RESPONSIBLE FOR COST ONLY:

(Lump-sum and Cost-plus Jobs)

Beginning inventory		\$ 15,000
*Purchases, audit period (ex-tax)		<u>350,000</u>
Total		\$365,000
Less ending inventory		<u>25,000</u>
Total costs to be accounted for		\$340,000
Taxable measure reported	\$360,000	
Less fixed assets, supplies, etc.	<u>40,000</u>	
Total reported on contracts		<u>320,000</u>
Indicated understatement		<u>\$ 20,000</u>

*Should be adjusted for accounts payable as beginning and end of audit period, if on a cash basis.

CONSTRUCTION CONTRACTORS

Example #2 — CONTRACTING OPERATIONS FOR WHICH TAXPAYER RESPONSIBLE
FOR COST OF INSTALLED MATERIALS AND SELLING PRICE OF
OVER-THE-COUNTER SALES:

Beginning inventory		\$ 15,000
Purchases, audit period (ex-tax)		<u>350,000</u>
Total		\$365,000
Less ending inventory		<u>25,000</u>
Total costs to be accounted for		\$340,000
*Less cost of over-the-counter sales:		
Sales	\$30,000	
Average M/U ratio	<u>50%</u>	
Cost of o/c sales (\$30,000 / 150%)		<u>20,000</u>
Total cost to be accounted for by jobs		\$320,000
Total taxable measure reported on contracts		<u>320,000</u>
Indicated understatement of contract costs		<u>NONE</u>

*Make similar adjustments for resales and other non-installed sales.

Example #3 — CONTRACTOR OPERATIONS FOR WHICH TAXPAYER RESPONSIBLE
FOR COST OF MATERIALS AND BILLED PRICE FOR FIXTURES
(Time and Materials Jobs — No tax charged):

Total costs to be accounted for		\$340,000
Add markup on fixtures billed:		
Fixture purchases	\$150,000	
Average M/U ratio	<u>10%</u>	
Estimated markup (\$150,000 x 10%)		<u>15,000</u>
Taxable measure to be accounted for on contracts		\$355,000
Reported taxable for contracts		<u>320,000</u>
Indicated understatement		<u>\$ 35,000</u>

The auditor in making the above cost analyses should exercise care to verify that tax-paid supply and expense items are charged to expense accounts rather than being included in material purchases. When a markup is used to establish costs of a portion of the sales, as is the case in examples #2 and #3, the auditor should verify the markup utilized.

In addition to the above examples, exhibits one through three include three different approaches involving more complex situations where accountability tests are used in accounting for taxable costs and sales in audits of construction contractors.

ALLOWANCE FOR WASTE AND BREAKAGE FOR GLASS CONTRACTORS

1205.12

When performing a cost accountability test on a contractor/retailer of glass and/or mirrors, consideration should be given to both storage breakage and wastage attributed to retail. Such allowances should be identified separately within the cost accountability test.

A loss/breakage amount established on over-the-counter sales is exempt from tax and should be clearly identified in the contractor's cost accountability test. However, once property is allocated to a construction contract, it cannot be included in the loss/breakage amount.

When performing a cost accountability test, the auditor should allow a percentage or tolerance for breakage of glass while in storage prior to being allocated to contracts or over the counter sales (Storage Breakage). If the glass is purchased for a specific construction contract, then no storage breakage percentage or tolerance is allowed for such glass. In determining the cost of retail sales, the cost factor should include a wastage factor for

unusable pieces of glass (Retail Wastage). However, if the glass retailer accounts for wastage by charging for the additional glass that is left from the cutting of the glass, then a retail breakage factor would not apply. For example, if a customer requests a 20x20 piece of glass and the retailer cuts this glass from a 20x24 piece of glass and the retailer charges for the larger piece of glass, then the retail breakage percentage would not apply.

In determining appropriate percentages or tolerances, the auditor must consider the type of glass (i.e. shower doors, mirrors, plate glass, sliding doors, etc.), the size of the shop, the procedures in place for handling and storing the glass, and the employee's experience in handling the glass. The auditor must provide comments in the working papers regarding the taxpayer's method of accounting of breakage.

Since the handling of glass varies from operation to operation, it would be impossible to establish an equitable statewide allowance. Accordingly, each case should be handled on its own merits. A statewide survey was conducted to help determine reasonable allowances. However the survey disclosed that the percentages varied greatly. In the most extreme case, the storage breakage was as high as five percent and the retail breakage over twenty percent. Whether or not a percentage or tolerance is allowed, the auditor must support their recommendation in the working papers. In addition, in the case of recommending an allowance, the auditor must fully explain how the percentage was arrived.

FIXED ASSETS — EXPENSE ITEMS**1205.15**

Fixed asset acquisitions and expense items should be verified. A key item to watch for in a contractor audit is the "self order" job involving withdrawals of materials from inventory for own use. Frequently, such withdrawals are recorded only by journal entries, or perhaps only in memo form.

DEDUCTIONS**1206.00****RESALES****1206.05**

The auditor should verify that such deductions represent sales of tangible personal property, rather than contracts involving improvement to realty.

Regulation 1521 provides that a subcontractor may not avoid liability for sales or use tax on materials or fixtures furnished and installed by him by taking a resale certificate from the prime contractor. On and after April 1, 1976, a subcontractor who furnishes and installs materials or fixtures is liable for tax on such transactions even though he may have a resale certificate from the prime contractor, and the prime contractor has collected tax from his customer. The tax so collected by the prime contractor is excess tax reimbursement and should be refunded to the customer. If it is not refunded to the customer, the prime contractor may be liable to the state for the amount of the excess tax reimbursement. (Refer to Section 1207.05)

A subcontractor or contractor may accept a resale certificate for fixtures which he installs only if the fixtures will be leased in place as tangible personal property by a lessor who is other than the lessor of the realty to which the fixtures are attached, and who will pay tax measured by rental receipts.

Prior to April 1, 1976, if the subcontractor can produce evidence that the tax has in fact been collected and remitted to the State on the item in question by the prime contractor based on billed price, such a transaction can be allowed. However, the taxpayer should be informed that the item in question is being accepted because the tax has been paid and that the resale certificate is not valid. The statement obtained from the prime contractor should not only confirm that tax has been paid, but also that the prime contractor will not claim refund on the transaction. An appropriate audit memo should also be prepared to be placed in the prime contractor's file.

USE OF RESALE CERTIFICATES BY CONSTRUCTION CONTRACTORS 1206.07

Contractors holding valid seller's permits may purchase fixtures, machinery and equipment for resale by issuing resale certificates to their suppliers. They may not purchase materials for resale unless they are also in the business of selling materials. Contractors should not purchase supplies and tools for resale unless they are actually engaged in the business of selling such property without previously using it.

Under Regulation 1521, a construction contractor generally is the consumer of materials which he furnishes and installs in the performance of a construction contract to improve real property. However, if the contract (other than a U.S. Government contract) explicitly provides for transfer of title to the materials prior to installation, and the sales price of the materials is separately stated in the contract, the contractor will be deemed to be selling the materials. In addition, if a contractor bills his customer an amount for "sales tax" computed upon a marked up billing for materials under a time and material contract, it will be assumed that he is selling the materials.

When a construction contractor is the seller of materials which he installs, the sale of the materials is a retail sale. Consequently, there are no circumstances under which a construction contractor may accept a resale certificate from a prime contractor, interior decorator, department store, or others for materials which he furnishes and installs.

A construction contractor (other than a U.S. Government contractor) is also generally regarded as the retailer of fixtures which he furnishes and installs and, under most circumstances, a construction contractor may not accept a resale certificate from a prime contractor, interior decorator, department store, or others for fixtures which he furnishes and installs. However, a construction contractor may furnish and install a fixture for a person, other than the owner or lessor of the realty, who intends to lease the fixture in place as tangible personal property and pay tax measured by rental receipts. In this case, the contractor may take a resale certificate from the lessor at the time of the transaction, and the sale to the lessor will be considered a sale for resale. Under no other circumstances may a construction contractor accept a resale certificate for fixtures which he furnishes and installs.

It should be noted that under no circumstances are contractors, who perform construction contracts for the United States Government, to be regarded as retailers of materials or fixtures they furnish and install on such contracts.

TAX-PAID PURCHASES RESOLD**1206.10**

If materials or fixtures are purchased tax paid or reported on Line 2, the contractor may claim credit for the cost of tax-paid materials or fixtures sold over-the-counter or reported on time and material contracts or retail sales. If the contractor sells short ends or pieces which are not used other than in severing them from larger units purchased by him and on which he has paid sales tax reimbursement or use tax, he may claim the deduction for tax-paid purchases resold, but the amount of the deduction may not exceed the price at which he sells such short ends or pieces.

BAD DEBTS**1206.15**

In all sales prior to April 1, 1976, where the contractor was considered the retailer, he was entitled to a bad debt deduction. Thus, on contracts where the contractor was considered the consumer, a bad debt deduction was not allowable. All other contracts involving fixtures and over-counter sales, are subject to provisions of the bad debt deduction. *Time and material contractors who mark up materials and charge tax on the marked up price can claim bad debts only on the markup — not on the total.*

In all sales effective April 1, 1976, where a contractor other than a United States contractor, is considered to be the retailer of materials which he installs, or the retailer of fixtures, or makes over-the-counter sales, he is entitled to a bad debt deduction in accordance with the provisions of Regulation 1642. On contracts where the contractor is considered to be a consumer, a bad debt deduction is not allowable.

CONSTRUCTION CONTRACTORS
SPECIAL PROVISIONS APPLICABLE TO CONTRACTORS

1207.00

**APPLICATION OF REGULATION 1700,
REIMBURSEMENT FOR SALES TAX**

1207.05

The auditor should check billings for tax reimbursement procedures, and in all cases reconcile sales tax accruals for the audit period.

A construction contractor who furnishes and installs materials under a lump-sum contract should not collect tax reimbursement from the customer. Tax so collected is excess tax reimbursement and should be refunded to the customer. The contractor is the consumer of materials furnished and installed and must pay tax or tax reimbursement measured by the sales price of materials to him. In addition, the contractor may be liable for the tax reimbursement which he charged to the customer.

On and after April 1, 1976, when a prime contractor collects tax from his customers with respect to materials or fixtures which have been furnished and installed by a subcontractor, the amount which the prime contractor collects as tax is excess tax reimbursement. Any such excess tax reimbursement should be refunded by the prime contractor to his customer. (Refer to Section 1206.05 and 1206.07.)

Should these types of situations be encountered, the following rules will be used to determine the contractor's liability for excess tax reimbursement:

- 1) For periods prior to April 1, 1976, only the amount of tax billed in excess of tax due on cost of materials installed is regarded as excess tax reimbursement. Reference should be made to Section 1206.05 for the handling of transactions where the prime contractor has collected tax from his customers with respect to materials or fixtures which have been furnished and installed by a subcontractor.
- 2) For periods on and after April 1, 1976 to December 31, 1978, the total amount billed as tax or tax reimbursement is regarded as excess tax reimbursement.
- 3) For periods on and after January 1, 1979, tax reimbursement and the treatment of excess tax reimbursement is governed by Section 1656.1 of the Civil Code. In general, this section provides that sales tax reimbursement is a matter of agreement between the buyer and seller. Consequently, if the contractor adds an amount designated as "sales tax" or "tax," he is not liable under the Sales and Use Tax Law to pay the excess amount to the state since the excess sales tax reimbursement provisions of the law was repealed effective January 1, 1979. However, if the contractor designates an amount as "use tax" and is considered a retailer for any reason, Section 6204 of the Sales and Use Tax Law applies; and the contractor is required to either refund the "use tax" to the customer or pay it to the state.
- 4) Some contractors itemize as tax the actual amount paid on their purchases of materials. Such amounts of tax will not be regarded as excess tax reimbursement if they are clearly identified as charges covering costs incurred by the contractor which are being passed on to a customer and do not represent tax or tax reimbursement which is legally imposed on the transaction. The tax cost billed the customer may not exceed the actual tax cost of the contractor, and the total amount billed may not exceed the lump-sum contract price. The representation by the contractor to the customer is the key. Generally speaking, if the amount in question is billed as "tax" or "sales tax" or "sales tax reimbursement," the charge should be treated as outlined in items 1 through 3, above.

JOB REPORTING BASIS — JOBS IN PROCESS

1207.10

The contractor becomes liable for use tax on materials, and should report tax thereon, in the reporting period in which the material is withdrawn from stock for use in performing a construction contract. Fixtures, however, should be included in the reporting period in which installation is made. Thus, where the auditor encounters an audit where the contractor is reporting his construction jobs at the time of completion rather than as outlined above, the auditor should establish as additional measure of tax in his audit any materials and fixtures on all jobs in process as of the end of the audit period.

TAXABLE COST — DELIVERY CHARGES**1207.15**

It should be noted that, particularly in the construction material industry, delivery of such items as lumber, concrete, structural steel, etc., is generally made by facilities of the retailer. Thus, in accordance with Regulation 1628, Transportation Charges, Section (b), tax may apply to such separately stated delivery charges, in addition to the sales price of the material. Frequently it will be found, however, that such transportation charges will be charged to "Transportation Expense" or "Freight In" rather than to "Purchases." Thus, the auditor should exercise care to verify that taxpayer has included such taxable transportation charges in recording and reporting ex-tax material cost.

OUT-OF-STATE CONTRACTORS**1207.20**

Section 6386 of the Sales and Use Tax Law provides an exemption from the sales tax for all tangible personal property sold to a construction contractor, even though such property is delivered in this State, provided the contractor is the holder of a valid seller's permit, and the property is used by the purchaser outside of this State in his performance of a contract to improve real property and as a result of such use is incorporated into and becomes a part of real property located outside this State. This exemption is available only if at the time of the purchase the contractor certifies in writing to the seller that he holds a valid California seller's permit (giving the number of that permit and identifying the property purchased) and states that the property will be used in the manner stated above. The certificate must be signed by the contractor or an authorized employee. A certification under Section 6386 given subsequent to the time of purchase is not valid and should not be recognized.

There are also two general provisions of the law which could apply to property used on out-of-state contracts:

- a) If the purchase of the property was exempt from the sales tax, as, for example, property purchased outside the State or materials purchased under a valid resale certificate by a contractor in the business of selling materials, the property would also be exempt from use tax if used solely outside this State.
- b) If the property installed outside the State is a "fixture", the contractor would be entitled to a deduction for tax-paid purchases resold. See Section 0419.25.

"LAST ACT" TEST**1207.25**

Dumping of rock, concrete, road oil, etc., may be either an improvement to realty, or a sale of tangible personal property, dependent upon whether the dumping by the seller or contractor constitutes the "last act." If the material must be spread, tamped, smoothed, or otherwise later set in place by another person, it constitutes a sales of tangible personal property.

LOCAL TAX**1207.30**

Regulation 1806, Construction Contractors, defines the basis upon which the state administered local sales and use taxes are applied to construction contractors. As noted therein, the jobsite is considered the place of sale of fixtures and the place of use of materials.

For purposes of allocating local sales and use tax on construction contractors, the following classification and procedures have been provided:

- a) If the contractor reports \$600 or less a year in local tax, the account is identified as an SR account and is assigned a countywide area code ending in "99" for the county where the place of business is located. No allocation is required for reporting by such a taxpayer.
- b) A contractor reporting more than \$600 per year local tax is identified as an SS account and requires a special local tax allocation by county of jobsite. Over-the-counter sales, however, are allocated to the specific location of taxpayer's place of business

Also see "Decision Tables" in Chapter 2 (Exhibits 42 and 43).

CONSTRUCTION CONTRACTORS

TRANSACTIONS AND USE TAXES

1207.32

The jobsite is considered the place of sale of fixtures and the place of use of materials. Construction contractors will be liable for tax on materials and fixtures withdrawn from ex-tax stock for use or for sale on jobs within transit district boundaries.

LIABILITY BY TYPE OF CONTRACT

1207.40

CONTRACTORS IN GENERAL (OTHER THAN UNITED STATES CONTRACTORS)

Kind of Item	How Acquired	Lump-Sum or Cost-Plus	Time and
Materials	Purchased Ex-Tax	Cost	Cost
	Purchased Tax Paid	None	None
	By conversion of realty*	None	None
Fixtures	Purchased Ex-Tax	Cost	Billed Price
	Purchased Tax Paid	None	Excess of billed price over cost
	Manufactured from ex-tax material by installing contractor	Prevailing price to contractors or, if that cannot be established, the amount stated in price lists, bid sheets or other records or manufactured cost, including profit, to contractor/manufacturer	Billed Price
	Manufactured from tax paid material by installing contractor	Excess of prevailing price, or manufactured cost, including profit, over tax paid cost of materials	Excess of billed price over tax paid cost

*Rock or dirt taken from contractor's own property

AUDIT MANUAL

LISTING OF MATERIALS, FIXTURES, AND MACHINERY AND EQUIPMENT 1207.45

The following listings of specific items of materials and fixtures should be helpful in conducting audits. The method of attachment to the realty or the use of the item may result in a change of classification.

Items usually regarded as materials:

Asphalt	Lime	Sand
Bricks	Linoleum	Sheetmetal
Builders' hardware	Lumber	Steel
Caulking Material	Macadam	Stone
Cement	Millwork	Stucco
Conduit	Mortar	Tile
Doors	Oil	Wall coping
Ducts	Paint	Wallboard
Electric wiring and connections	Paper	Wallpaper
Flooring	Piping, valves, and pipe fittings	Wall-to-wall carpeting (When affixed to the floor)
Glass	Plaster	Weather-stripping
Gravel	Power poles, towers, and lines	Windows
Insulation	Putty	Window screens
Lath	Reinforcing mesh	Wire netting and screen
Lead	Roofing	Wood preserver

Items usually regarded as fixtures:

Air conditioning units	Plumbing fixtures
Awnings	Refrigeration units
Burglar alarm and fire alarm fixtures	Signs
Cabinets, counters, and lockers (prefabricated)	Telephone switchboards and instruments
Electric generators (affixed to and accessory to a building, structure or fixed works)	Television antennas
Elevators, hoists, and conveying units	Transformers and switchgear
Furnaces, boilers, and heating units	Vault doors and equipment
Lighting fixtures	Venetian blinds

Lists of items which are usually:

Machinery and Equipment

Drill presses
Electric generators (unaffixed, or, if affixed, which meet the requirements of Regulation 1521, subparagraph (a)(1)(B)(6))
Lathes
Machine tools
Moving parts of cranes
Printing presses

Not Machinery or Equipment

Fixtures and materials as defined in Regulation 1521
Wiring, piping, etc., used as a source of power, water, etc., for machinery and equipment
Radio transmission antennas
Large tanks (i.e., over 500-barrel capacity)
Fire alarm systems
Street light standards
Cooling towers other than small prefabricated cooling units

Accountability Test (Based on Taxable Cost of Construction Contracts)**Chapter 12****Exhibit 1**

ACCOUNTABILITY TEST FOR PERIOD
11-1-xx to 11-31-xx
BASED ON TAXABLE COST OF CONSTRUCTION CONTRACTS

Beginning Inventories 11-1-xx:				
Goods In Warehouse				\$ 8,540
Materials In Jobs In Process				1,504
Purchases (Adjusted For Accounts Payable If on Cash Basis)				<u>488,612</u>
Cost of Goods Available For Sale or Use				\$498,656
Less: Ending Inventories 10-31-xx				
Goods In Warehouse				<u>\$ 15,980</u>
Costs To Be Accounted For				\$482,676
Less: Costs of Sales				
	<u>COST OF</u>	<u>COST OF T & M</u>	<u>COST OF</u>	
	<u>RETAIL SALES</u>	<u>CONT. FIXTURES</u>	<u>RESALES</u>	
(a) Sales	\$27,153	\$57,623	\$6,211	
(b) Audited Markup Factor(Per Test)	<u>1.3337</u>	<u>1.6421</u>	<u>1.4</u>	
Cost of Sales (Line a ÷ b)	\$20,359	\$35,091	\$4,436	\$ 59,886
	Subtotal			\$422,790
Less: Tax Paid Purchases — Lump Sum Contracts				18,481
Audited Ex-Tax Costs of Construction Contracts (Lump Sum)				\$404,309
(c) Recorded Ex-Tax Costs of Construction Contracts (Lump Sum)				<u>312,838</u>
(d) Understatement				\$ <u>91,471</u>
<u>Analysis of Understatement:</u>				
(e) Ending Inventory — Materials In Jobs In Process				<u>\$ 4,315</u>
(f) Other Errors In Contracts (Line d – e)				<u>\$ 87,156</u>
Percentage of Recurring Errors (Line f ÷ c)				27.8598%

Note: This schedule illustrates an Accountability Test based on construction contract costs. The materials were reported on a job-completed basis and billed on a lump sum basis. No fixtures were manufactured by the contractor. Some fixtures were billed lump sum, others were billed time and materials. Tax was added to the billed price of fixtures on time and material jobs. Since inventories were found accurate, separate accountability tests were made for each fiscal year of audit period.

**Accountability Test (Based on Taxable Measure
of Construction Contracts)**

Exhibit 2

ACCOUNTABILITY TEST FOR PERIOD

11-1-xx to 10-31-xx

BASED ON TAXABLE MEASURE OF CONSTRUCTION CONTRACTS

Beginning Goods In Warehouse Inventory 11-1-xx			\$ 8,100
Purchases (Adjusted For Accounts Payable If on Cash Basis)			<u>482,562</u>
Cost of Goods Available For Sale or Use			\$490,662
Less: Ending Inventory — Goods In Warehouse 10-31-xx			<u>\$ 14,258</u>
Costs to be Accounted For			\$476,404
Add: Markup On Fixtures Billed T and M			
(a) Sales of Fixtures		\$54,704	
(b) Audited Markup Factor (Per Test)		1.64	
(c) Cost of Fixtures (Line a ÷ b)		<u>33,356</u>	
Markup (Line a – c)			<u>21,348</u>
	Subtotal		\$497,752
Less: Computed Costs of Sales			
	<u>RETAIL SALES</u>	<u>RESALES</u>	
(d) Sales	\$55,121	\$41,210	
(e) Audited Markup Factor (Per Test)	1.33	1.40	
Costs of Sales (Line d ÷ e)	<u>41,444</u>	<u>29,436</u>	<u>70,880</u>
	Subtotal		\$426,872
Less: Tax Paid Purchases – Lump Sum and T & M Contracts			2,510
Audited Taxable Measure of Contracts			\$424,362
Recorded Taxable Measure of Contracts			<u>371,215</u>
Understatement (Unidentified Differences)			<u>\$ 53,147</u>

Note: This schedule illustrates a 12-month Accountability Test based on taxable measure of contracts. The materials were reported when withdrawn from inventory for use in a contract and were billed lump sum. All fixtures were billed time and material with no tax added. Inventories were found accurate. Therefore, separate accountability tests were made for each fiscal year.

Reconciliation of Taxable Measure (Construction Contracts and Sales)

RECONCILIATION OF TAXABLE MEASURE FOR PERIOD 1-1-xx to 12-31-xx CONSTRUCTION CONTRACTS AND SALES

Beginning Inventories 1-1-xx:

Goods In Warehouse		\$ 30 000
Materials In Jobs In Process		30,000
(a) Purchases (Cash Basis)		355,000
Add: Accounts Payable 12-31-xx		<u>25,200</u>
Subtotal		\$440,200

Less: Ending Inventories 12-31-xx

Goods In Warehouse	\$50,000	
Accounts Payable 1-1-xx	5,200	
Tax Paid Supplies Included In Line (a)	<u>2,000</u>	<u>57,200</u>
Total Costs To Be Accounted For		\$383,000

Less: Tax Paid Purchases Resold

Cost of Sales For Resale		3,000
Sales	11,000	
Divided By Audited Markup Factor (Per Test)	<u>1.10</u>	<u>10,000</u>
Subtotal		\$370,000

Add Markups:

T&M TAX ADDED OVER THE COUNTER

(b) Sales	\$45,000	\$80,000	
(c) Audited Markup Factor (Per Test)	1.50	1.60	
(d) Cost of Sales (Line b ÷ c)	30,000	50,000	
Markup (Line b – d)	<u>\$15,000</u>	<u>\$30,000</u>	<u>45,000</u>
Audited Taxable Measure			\$415,000
Reported Taxable Measure			261,000
Understatement			<u>\$154,000</u>
<u>Analysis of Understatement:</u>			
Unidentified Differences			<u>\$114,000</u>
Materials — Jobs In Process 12-31-xx			<u>\$ 40,000</u>

Note: This schedule illustrates a three-year reconciliation of taxable costs and sales from the records to reported taxable measure for a construction contractor who had no fixtures (i.e., a flooring contractor). Tax was reported on materials on a job completion basis. Some construction contracts were billed lump sum, remainder were billed time and materials. Tax was charged on billed price of T & M jobs.